

# Text versus Context: The Failure of the Unitary Law of Contract Interpretation

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Modern contract law is nominally unitary; that is, a single set of legal rules (and presumably governing policies) applies to all enforceable promises regardless of the status of the contracting parties. Unfortunately, there are significant inefficiencies in a system that interprets the contracts between sophisticated parties who negotiate multi-million dollar agreements with the aid of competent counsel in precisely the same way as it regulates “click-wrap” contracts between individual consumers and merchant sellers over the purchase of \$50 of products on the internet. Prominent among those inefficiencies is the confusion that results from the fractious debate between textualist and contextualist theories of interpretation. In broad brush, the differences between the two approaches are apparent: Textualist theories look principally to the written agreement between the parties for the terms of the contract and to determine the meaning of those terms; contextualist theories look beyond the writing, to pre- and post-contractual oral and written evidence of what the parties intended.

Textualist theories undergird the formal common law doctrines of contractual interpretation, such as the parol evidence and plain meaning rules. Both of these rules are designed to give parties some control over the process courts will use to interpret their contracts. The parol evidence rule enables parties to restrict the admissibility of certain kinds of evidence in any future adjudication of disputes over their agreement: When parties provide that their writing is “fully integrated” and reflects all the terms of the contract, they forfeit the right in subsequent litigation to prove understandings they declined to include in their integrated writing. Similarly, the best understanding of the plain meaning rule treats it as a device for preserving a reservoir of

terms with clear meanings that cannot be contradicted in adjudication by contextual evidence supporting a different meaning.

On this account, the plain meaning rule makes available a public fund of terms with judicially protected meanings on which contractual parties can rely to communicate their definitive commitments to each other and to courts. From the textualist perspective, therefore, the parol evidence and plain meaning rules can be viewed as tools for parties to use, respectively, to restrict and provide the evidence courts will use to interpret that portion of their agreement that they intend to make legally enforceable.

This straightforward account of the interpretation doctrines as tools for parties to use in expressing their contractual intent is relatively uncontroversial. But courts sometimes perceive a conflict between the formal rules governing contractual interpretation and the principle of honoring the expressed intention of the parties as revealed by contextual evidence that otherwise would be excluded by the governing rules. Contextualist courts confronted with this apparent conflict are predisposed to deploy their equitable powers to avoid the application of formal contract doctrines that appear to achieve an unfair or unjust result. Thus, in jurisdictions following the lead of the Second Restatement of Contracts<sup>1</sup> and in all contracts governed by the Uniform Commercial Code (UCC),<sup>2</sup> contextualist theories of interpretation advocate a two-stage interpretive regime. Under this regime, written contract language is treated merely as establishing prima facie terms, which courts can (and should) override by considering evidence of the context of the transaction if they believe that doing so is necessary to “correct” the parties’ written contract by realigning it with its “true” meaning. This ex post judicial determination of the contractual obligation serves as a fallback mechanism whenever a court determines that

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<sup>1</sup> See generally Restatement (Second) of Contracts §§210 Comment b; 212, Comment b; 214 (1979).

<sup>2</sup> Article 2 of the UCC governs contracts for the sale of goods. See generally Uniform Commercial Code (hereinafter UCC) §§2-202(a), Comment 1(b), and Comment 2; 1-303, Comment 1.

interpreting written contract terms according to the formal rules of interpretation will fall seriously short of achieving the parties' purposes. In short, under the contextualist view every contract by default should come with a judicial insurance policy against written contract terms that, viewed in proper context, have turned out to have ill-served the parties' objectives.

This contextualist regime of contract interpretation rests on the powerful intuition that most parties, both individual consumers as well as commercially sophisticated firms, would prefer courts to take advantage of hindsight in assisting the parties to achieve their contractual objectives. Indeed, had the parties known at the time of formation what the court knows at the time of adjudication, the parties themselves would likely have written different terms. It seems perverse for a court to insist on holding parties to the plain meaning of terms that it knows the parties themselves would have rejected had they known what the court knows. Holding parties to their formally specified contract terms when those terms no longer (or never did) constitute a reasonable interpretation of the parties' shared intent would exalt formal doctrine over substance.

As compelling as it seems, however, the contextualist justification for contract interpretation rests on an unsupported premise: It presumes that all parties want courts to reinterpret the formal terms of a written contract in light of the surrounding context of the transaction so as to better achieve their shared contractual purposes. But there is good reason to doubt that commercially sophisticated parties typically, let alone always, prefer this method of interpreting their contracts. Rather than an interpretive rule that subordinates written contract terms to ex post judicial revision, both theory and available evidence suggests that sophisticated parties would prefer a regime that excludes contextual evidence unless the parties have expressly indicated their intent to delegate authority to a court to consider surrounding context evidence. By eliminating the risk that courts will erroneously infer the parties' preference for contextual interpretation, such a regime reduces the costs of contract enforcement and enhances the parties' control over the content of their contract. That control, in turn, permits sophisticated commercial parties to implement the most efficient strategies for contract design available to them.

Those who argue for mandatory contextualist interpretations often justify the abandonment of textualism as a necessary prophylactic against the exploitation of unsophisticated individuals who enter into contracts with sophisticated parties who supply written contract terms

that alter previously settled understandings. As Justice Traynor famously wrote: “The party urging the spoken as against the written word is most often the economic underdog, threatened by severe hardship if the writing is enforced.”<sup>3</sup> And herein lies the dilemma of a unitary contract law: Assuming that these concerns are valid reasons for imposing a mandatory contextualist regime in contracts between individual consumers and firms, they do not apply to the firm to firm negotiated contracts that are the bread and butter of commercial contracting practice.

In Part I of this Essay, I describe the conundrum that results from the historical anomaly of the integration of the common law and equity into a unitary contract law. In this Part, I show how and why the current debate came to be framed in such peculiar ways. I then turn in Part II to offer plausible ways in which the Gordian knot of contract interpretation can be untied.

## **I. *The Interpretation Conundrum***

### *A. The Divide between Text and Context*

Legal enforcement of incomplete contracts necessarily requires the state to interpret the terms contracting parties use to allocate contractual risk. Interpreting disputed contracts presents the state with the opportunity to protect (and even improve) the efficacy of those terms for future parties. Since interpretation disputes are the largest single source of commercial contract litigation,<sup>4</sup> if the courts perform the interpretation function inconsistently, the costs of contracting

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<sup>3</sup> *Masterson v. Sine*, 436 P. 2d 561 (1968).

<sup>4</sup> An early empirical study found that 26% of a sample of five hundred cases raised interpretation and parol evidence issues. Harold Shepherd, *Contracts in a Prosperity Year*, 6 *Stan. L. Rev.* 208, 223 (1954); see also David A. Dilts, *Of Words and Contracts: Arbitration and Lexicology*, *Disp. Resol. J.*, May-July 2005, at 41, 43 (“The construction of contract language is the controversy most evident in contract disputes.”); John P. Tomaszewski, *The Pandora’s Box of Cyberspace: State Regulation of Digital Signatures and the Dormant Commerce Clause*, 33 *Gonz. L. Rev.* 417,

will rise. Interpretive questions thus are both significant and complex. But despite the importance of having consistent, predictable rules of interpretation, contract interpretation is the least settled question in contemporary contract doctrine and scholarship. Instead, contemporary courts and scholars debate vigorously the relative merits of two polar and dichotomous approaches to the interpretation of contracts.

At one pole is the textualist argument that defends the traditional common law approach to interpretation, an approach that a large majority of common law courts continue to follow.<sup>5</sup> This interpretive approach privileges integrated written contracts over context evidence that purports to show that the agreement contained additional or different terms.<sup>6</sup> In addition it bars context evidence designed to show that parties intended facially clear and unambiguous language to be understood in non-standard ways.<sup>7</sup>

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432 (1997-1998) (most contract litigation involves disputes over construction of the terms in a contract”).

<sup>5</sup> A strong majority of U.S. courts continue to follow the traditional, textualist or “formalist,” approach to contract interpretation. A state by state survey of recent court decisions shows that thirty-eight states follow the textualist approach to interpretation. Nine states, joined by the UCC for sales cases and the Restatement (Second) of Contracts, have adopted a contextualist or anti-formalist interpretive regime. The remaining states’ doctrines are indeterminate.

<sup>6</sup> This issue is addressed by the parol evidence rule. The rule holds that when parties choose to fully integrate a final written agreement, they forfeit the right in subsequent litigation to prove understandings they declined to include in their integrated writing

<sup>7</sup> The plain meaning rule addresses the question of what legal meaning should be attributed to the

Textualist courts, such as New York, use a hard parol evidence rule that gives presumptively conclusive effect to “merger” clauses which expressly exclude contextual evidence as to the intention of the parties. In the absence of a merger clause, New York courts determine whether contextual evidence is admissible by applying a “four corners” presumption in favor of textualism if the contract is fully integrated if it appears final and complete on its face.<sup>8</sup> Scholars who defend textualist arguments ground their analysis on a particular contracting paradigm: the negotiated contract between sophisticated commercial parties.<sup>9</sup> Textualist arguments thus focus on the importance of contract design and the insight that for these parties context is endogenous; the parties can embed as much or as little context into an agreement as they wish. In this way, sophisticated parties can economize on contracting costs by shifting costs between the front end

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contract terms that the parol evidence rule has identified. Under a plain meaning interpretation, when words or phrases appear to be unambiguous, extrinsic evidence of a possible contrary meaning is inadmissible.

<sup>8</sup> See, e.g., *Morgan Stanley High Yield Sec., Inc. v. Seven Circle Gaming Corp.*, 269 F. Supp. 2d 206 (S.D.N.Y. 2003) (holding that the prior agreement is excluded where the writing appears in view of thoroughness and specificity to embody a final agreement). In addition, merger clauses are given virtually conclusive effect in New York. See *Tempo Shain Corp. v. Bertek, Inc.*, 120 F.3d 16, 21 (2d Cir. 1997) (“Ordinarily, a merger clause provision indicates that the subject agreement is completely integrated, and parol evidence is precluded from altering or interpreting the agreement”).

<sup>9</sup> See Alan Schwartz and Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 *Yale L.J.* 541 (2003).

(or drafting stage) and the back end (or enforcement stage) of the contracting process.<sup>10</sup>

At the other pole is the contextualist approach to interpretation. Contextualist courts and commentators are reluctant to endorse formal rules for determining either the terms of a contract or the presumed meaning of those terms once they have been identified.<sup>11</sup> They argue that formal interpretive rules that exclude certain categories of extrinsic evidence deprive the fact finder of potentially relevant information and thus distort the court's assessment of what the parties meant by their agreement. Contextualist courts, such as California, therefore favor a soft parol evidence rule. Here the test for integration admits extrinsic evidence notwithstanding an unambiguous merger clause or, absent such a clause, notwithstanding the fact that the writing otherwise appears final and complete on its face.<sup>12</sup> These courts regard a merger clause as raising only a rebuttable presumption of integration, one that is subject to being overridden by

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<sup>10</sup> For a discussion of how contracting parties can economize on total contracting costs by shifting costs between the drafting or front end of the contracting process and the adjudication or back end of the process, see Robert E. Scott and George G. Triantis, *Anticipating Litigation in Contract Design*, 115 *Yale L. J.* 814 (2006).

<sup>11</sup> Contextualist interpretive principles are exemplified by the Uniform Commercial Code and the Second Restatement of Contracts. California is the most significant contextualist jurisdiction.

<sup>12</sup> *Pac. Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co.*, 442 P.2d 641, 645 (1968) (“[R]ational interpretation requires at least a preliminary consideration of all credible evidence offered to prove the intention of the parties”); see also *Int'l Milling Co. v. Hachmeister, Inc.*, 110 A. 2d 186 (1955) (extrinsic evidence of negotiations and antecedent agreements admissible to show buyer had not assented to the contract as a complete integration of the contract despite the presence of an express merger clause).

extrinsic evidence that the parties lacked such intent. The contextualist approach is framed by a very different paradigm from the one that justifies textualism: here the argument focuses on contracts between parties to standardized transactions (the consumer context) or contracts embedded in customary norms and terms of trade (the sales context). Both of these transactional prototypes undermine the assumptions of individualized contract design that animates the textualist view.

This brief description of the arguments and their key assumptions exposes a deep puzzle: since the central paradigms that support each approach to interpretation are not overlapping, what explains a debate in which each side wishes to gain primacy over the other? The answer lies in the unitary nature of contract law and doctrine. Contract interpretation rules are both unitary and mandatory; that is, when a court (or legislature) chooses either a textualist or a contextualist approach to interpretation, that choice applies to all transactional prototypes, and particular parties cannot choose *ex ante* to have their contract interpreted according to the disfavored approach. Thus the on-going interpretation debate is binary—either text or context—and a victory in any state is total for one approach or the other.

Viewed in this light, the effects of the choice between text and context are clear: The textualist plain meaning rule operates in tandem with a hard parol evidence rule to reduce expected adjudication costs but at the cost of truncating the context evidence available to the court. If the contract is fully integrated, and if contractual terms are facially clear, then the dispute will be resolved at summary judgment. Parties who want the court to see additional evidence, but avoid trials, can (and must) embed the evidence in the contract itself. A contextual interpretive rule, on the other hand, shifts costs from the drafting or front end of the contracting process to the back end litigation stage. Parties who write simple contracts in rich context environments can thus economize on front end costs and delegate discretion to courts to interpret the express terms in light of the context evidence revealed in a full trial.<sup>13</sup>

### *B. The Sources of a Unitary Law of Contract Interpretation*

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<sup>13</sup> See Scott and Triantis, *supra* note 10.

The current regime of American contract interpretation applies two different sets of doctrines to resolve a contract dispute.<sup>14</sup> The first set consists largely of those doctrines that originated in the English courts that produced the corpus of the English common law from the twelfth to the nineteenth century.<sup>15</sup> These doctrines consists of rules – such as the parol evidence and plain meaning rules -- that were administered strictly, without exceptions to provide for cases in which the application of a rule appeared to defeat its purpose. The second set of doctrines consists largely of equitable principles that originated in the English Court of Chancery, which exercised overlapping jurisdiction with the common law courts.<sup>16</sup> These principles often required judges to exercise discretion on a case-by-case basis. The result was two competing systems, often with incompatible procedural and substantive doctrines, yet overlapping in jurisdiction.<sup>17</sup> Conflicts among these doctrines were inevitable.

The American common law of contracts is thus suffused with legal doctrines, providing relatively clear and objective rules, combined with equitable doctrines directing courts to circumvent or override these rules whenever a judge believes that application of the legal doctrine would produce a result that is contrary to the doctrine’s own purpose or is otherwise unjust. The rules governing the interpretation of contracts are prime exemplars of this structure: Along with the historically legal contract doctrines, such as the plain meaning rule<sup>19</sup> and the parol

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<sup>14</sup> The discussion in this part draws on Jody S. Kraus and Robert E. Scott, Contract Design and the Structure of Contractual Intent, 84 N.Y.U. L. Rev. 1023 (2009).

<sup>15</sup> J. H. Baker, An Introduction to English Legal History 12 (4th ed. 2002).

<sup>16</sup> Id. at 12, 100-1.

<sup>17</sup> Baker, supra note 15, at 111.

<sup>19</sup> The common law applied “to documents a rule of construction that the words had to be given

evidence rule,<sup>20</sup> American contract law also absorbed equitable doctrines specifically designed to vitiate the common law rules of interpretation.<sup>21</sup> As a consequence, contract interpretation law is torn between the prospective regulatory perspective of the common law and the retrospective dispute-resolution perspective of equity.

The tension between the common law rules of interpretation and the equitable exceptions to those rules was rationalized by Samuel Williston, one of the great twentieth century treatise writers, into a more or less coherent set of general rules that could be applied predictably by common law courts.<sup>22</sup> Willistonian formalism rested on several basic claims: that contract terms could be interpreted according to their plain meaning; and that written terms have priority

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their ordinary meaning.” *Id.* at 226.

<sup>20</sup> Baker, *supra* note 15, at 324-25.

<sup>21</sup> See, e.g., William Story, *Commentaries on Equity Jurisprudence*, §§ 153-157 (W.E. Grigsby, ed. 1884) (describing the equitable exceptions to the parol evidence rule).

<sup>22</sup> See, e.g., Samuel Williston, *Contracts* ' 631 (3d ed. 1961) (“The parol evidence rule requires, in the absence of fraud, duress, mutual mistake or something of the kind, the exclusion of extrinsic evidence, oral or written, where the parties have reduced their agreement to an integrated writing.”). For discussion, see Dennis M. Patterson, *Good Faith, Lender Liability, and Discretionary Acceleration: Of Wittgenstein, and the Uniform commercial Code*, 68 *Tex. L. Rev.* 169, 187-88 (1989).

over unwritten expressions of agreement.<sup>23</sup> Williston viewed merger clauses as presumptively establishing a total integration of the agreement sufficient to exclude extrinsic evidence.<sup>24</sup> In the absence of a merger clause, he argued that if the writing appeared to be a complete instrument, contextual evidence should be excluded apart from the exceptional case where the additional terms might naturally be considered to form a separate agreement.<sup>25</sup> These views on parol evidence had a significant influence on many state courts as they decided interpretation disputes and Williston's formalist approach to interpretation was subsequently enshrined in the First Restatement of Contracts.<sup>26</sup>

The underlying tensions between law and equity were just beneath the surface and were elevated to prominence by the legal realists, whose leaders included Arthur Corbin and Karl Llewellyn. Corbin advanced the view that the Willistonian rules governing interpretation were empty formalizations and that interpretation issues were context specific. In his view, courts applied the rules tactically in order to pursue overarching policy principles of fairness and natural justice. Instead, argued Corbin, courts should determine the actual intention of the parties, and all relevant evidence should be considered on the issue of intent.<sup>27</sup> Thus the very evidence whose admissibility was being challenged would be admissible on the issue of whether or not the writing

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<sup>23</sup> Patterson, *id.* at 187-88.

<sup>24</sup> 11 Williston on Contracts § 33:2. For discussion, see Joseph M. Perillo, Calamari and Perillo on Contracts 115-116 (6<sup>th</sup> ed. 2009).

<sup>25</sup> 11 Williston on Contracts §32:25.

<sup>26</sup> Restatement of the Law of Contracts §240 (1932).

<sup>27</sup> 6 Corbin on Contracts §577 (1951).

alone was to govern.<sup>28</sup> Quite clearly, Corbin’s approach severely undercut the application of the traditional parol evidence rule. In order for the court to reach a just result, the context of the transaction was a necessary, indeed an essential, feature of any adjudication.<sup>29</sup>

Llewellyn’s contextualism was rooted in his idea that courts should seek the “situation sense” of a bargain by locating it in the practices of commercial parties.<sup>30</sup> He believed that courts can and should determine the nature of any transaction by first adverting to the standard practices of the relevant trade. Moreover, because the signals provided by these practices was uncertain, legal incorporation through the common law process was necessary in order to resolve the troublesome cases where the relevant norms were in dispute. Llewellyn addressed the incorporation objective in drafting those portions of the UCC governing contracts for the sale of goods by reversing the Willistonian presumption that the parties writings were the definitive elements of the agreement.<sup>31</sup> Rather, Article 2 of the UCC explicitly invites an examination of context by defining the content of an agreement to include trade usage, prior dealings and the parties experience in forming the contract.<sup>32</sup> The parol evidence rule under the

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<sup>28</sup> Id. at § 582.

<sup>29</sup> Corbin’s view was that even if the contract was an unambiguous integration, all relevant extrinsic evidence should be admissible on the issue of the meaning of the agreement. 5 Corbin on Contracts §24.7-24.9 (Kniffin 1998).

<sup>30</sup> Robert E. Scott, The Rise and Fall of Article 2, 62 La. L. Rev. 1009, 1023-4 (2002).

<sup>31</sup> Id. at 1037-8.

<sup>32</sup> UCC § 1-201(3) (2010) defines “agreement” as the “bargain of the parties in fact as found in their language or by implication from other circumstances, including course of dealing or usage of trade or course of performance as provided in this act.”

Code thus admits inferences from trade usage even if the express terms of the contract seem perfectly clear and are apparently integrated.<sup>33</sup>

And so, the battle between text and context was fully joined. As time has passed, the common law courts have proved remarkably faithful to the Willistonian accommodation to interpretation. A large majority of courts retain “hard” parol evidence and plain meaning rules even while recognizing equitable exceptions for fraud, misrepresentation and the like. A minority of courts has adopted Corbin’s commitment to context and, in the domain of sales law, the UCC remains fully committed to Llewellyn’s incorporation project.

### *C. Dueling Normative Justifications*

The path dependence that led to the development of the unitary American law of contract explains, if not justifies, the lack of consensus on how courts should interpret contracts. But the debate between contextualism and textualism is intense precisely because, given certain premises, each approach can be normatively justified. To fully understand the current dilemma, therefore, one must first appreciate the arguments that support both interpretive methodologies.

1. The Justification for Contextualism. Under autonomy theories of contract, the parties’ agreement has normative force because the parties actually agreed to it.<sup>34</sup> Thus the law’s task is to enforce the parties’ will the better to permit parties to realize their goals. These

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<sup>33</sup> UCC § 2-202, cmt 1,2 (2003).

<sup>34</sup> Most autonomy-based theories are premised either on a notion of consent or the exercise of will, such as the making of a promise. For discussion, see Robert E. Scott and Jody S. Kraus, *Contract Law and Theory* 23-26 (4<sup>th</sup> ed. 2007).

theories of contract require courts to find out, as far as is possible, what the parties actually meant by the words they used.<sup>35</sup> A contextualist approach to interpretation appears to follow logically from this freedom of contract premise: it invites courts first to learn about the commercial context and then to interpret express contract terms in light of that context.

Implicit in a contextual approach are two key assumptions: 1) that courts have the capability of learning about the commercial context, and 2) that the parties could and would have completed the contract as the court did had they been able to do so. This second assumption requires one to accept the empirical claim that the parties did not complete the contract in question because the costs of specifying the missing terms (including the cost of uncertainty) exceeded the benefits to the parties.

These two assumptions derive from quite separate concerns about the common law of contract. The assumption that courts can accurately recover the context undergirds the contextualist approach to commercial sales contracts championed by Karl Llewellyn and enshrined in Article 2 of the UCC.<sup>36</sup> A separate concern about the risk of fraud and exploitation

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<sup>35</sup> It is universally understood that a court's role in interpreting a contract is to determine the intentions of the parties. Intent, in turn is determined objectively and prospectively. In other words, a court is directed to recover the parties' objectively manifested intentions concerning both the objectives or "ends" of their agreement and the "means" they may have chosen to determine those ends should they later dispute the meaning of the agreement.

<sup>36</sup> This notion of incorporation of custom and practice is deeply imbedded in the Code. UCC §1-303, Comment 3 provides that "[Usages and customs] furnish the background and give particular meaning to the language used [in the contract] and are the framework of common understanding controlling any general rules of law which hold only when there is no such understanding." For discussion, see Robert E. Scott, *The Rise and Fall of Article 2*, 62 *La. L. Rev.* 1009 (2002).

in consumer transactions animates the second contextualist assumption. Those who argue for mandatory contextualist interpretations often justify such rules as necessary to prevent exploitation of unsophisticated individuals who enter into contracts with sophisticated parties who supply the written contract terms.<sup>37</sup> By examining the context ex post, courts are thought to be able to monitor the process by which certain terms were reduced to writing, thereby protecting unsophisticated parties from difficult-to-detect forms of exploitation.

In sum, the contextualist approach is framed by a very different paradigm from the one that justifies textualism: here the argument focuses on contracts between parties to mass-market, standardized transactions (the consumer context) or contracts embedded in customary norms and terms of trade (the sales context). Both of these transactional prototypes undermine the assumptions of individualized contract design that animates the contextualist view. The contextualist regime of contract interpretation therefore rests on the intuition that contracting parties would prefer courts to take advantage of hindsight in assisting the parties to achieve their contractual objectives.

Despite the fact that common law courts traditionally have followed a textualist approach, the UCC and the Second Restatement continue to encourage courts to be contextual.<sup>38</sup> Conventional scholarly wisdom has long held that the Code's interpretive approach represents a significant improvement over the formalism of the common law.<sup>39</sup> This is because contextualism is assumed to ascertain the parties' intentions more accurately. More evidence usually is better

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<sup>37</sup> See e.g., *Masterson v. Sine*, supra note 3.

<sup>38</sup> See UCC §§ 1-205, 2-202 and comments. For discussion, see Robert E. Scott, *The Uniformity Norm in Commercial Law: A Comparative Analysis of Common Law and Code Methodologies in The Jurisprudential Foundations of Corporate and Commercial Law* 149-92 (J. S. Kraus and S. D. Walt, eds., 2000).

<sup>39</sup> See, e.g., Perillo, supra note 24.

than less. Particular parties may have intended apparently clear language to be read in a nonstandard way, or acted under the contract in surprising ways given the contractual language. Excluding evidence of these parties' prior negotiations or practices under their contract risks interpreting the contracts in opposition to the parties' actual intentions.<sup>40</sup>

2. The Justification for Textualism. As compelling as it seems, however, the contextualist justification of a two-stage regime of contract interpretation rests on the premise that *all* parties want courts to reinterpret the formal terms of a contract in light of the surrounding context of the transaction so as to better achieve their shared contractual purposes. But there is good reason to believe that commercially sophisticated parties would prefer a regime that follows the parties' instructions specifying when to strictly enforce formal contract terms and when to delegate authority to a court to consider surrounding context evidence. By eliminating the risk that courts will erroneously infer the parties' preference for contextual interpretation, such a regime reduces the costs of contract enforcement and enhances the parties' control over the content of their contract. That control, in turn, permits sophisticated commercial parties to implement the most efficient design strategies available to them.

Given the two assumptions that support the contextualist claims, the argument against using a contextualist approach for all contracts requires evidence that 1) courts do not, in fact, learn about the relevant commercial context; and 2) sophisticated commercial parties are not readily susceptible to exploitation by a counterparty, and they would prefer to limit the back-end cost of interpretation that contextualism requires.

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<sup>40</sup> Of course, the reverse could be true. The Code directs courts to construe express terms and extrinsic evidence from practices or usages as consistent with each other. But sometimes the parties may actually have intended that their clear language should be read in the standard (plain meaning) way despite the fact that the language itself conflicts with the prior practices and negotiations of the parties. In such a case, a court that relies too heavily on context risks misinterpreting the parties' actual intentions.

Adherents of textualism offer several justifications to support their claims. First, courts usefully create standard vocabularies for the conduct of commercial transactions.<sup>41</sup> When a phrase has a set, easily discoverable meaning, parties who use it will know what the phrase requires of them and what courts will say the phrase requires. By insulating the standard meaning of terms from deviant interpretations, this strategy preserves a valuable collective good, namely a set of terms with a clear, unambiguous meaning that is already understood by the vast majority of commercial parties.<sup>42</sup>

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<sup>41</sup> See Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 *Nw. U. L. Rev.* 847, 853-856 (2000); Scott, *The Uniformity Norm*, *supra* note 38, at 157-158; Alan Schwartz, *Contract Theory and Theories of Contract Regulation*, 92 *Revue D'Economie Industrielle* 101 (2000).

<sup>42</sup> What does it mean, then, to interpret contracts according to their “plain meaning”?

Proponents of a contextual approach to interpretation have argued that meaning is necessarily contextual. To be sure, at one level, the debate over plain meaning raises deep philosophical questions about the nature and knowledge of meaning. In its purely philosophical form, the debate turns on whether any terms have on their face a unique, a contextual plain meaning. But in commercial litigation the pressing question is not this deep philosophical one, but whether courts should seek to vindicate the meaning the parties actually intended or instead to assign terms a more objective meaning. Even if terms do not, strictly speaking, have a unique, plain meaning, the meanings any terms can be given range along a continuum from purely subjective to largely objective. Thus, while parties might attach purely subjective meanings to ordinary words, this does not demonstrate that the same terms do not admit of relatively more objective meanings. For discussion, see Robert E. Scott and Jody S. Kraus, *supra* note 34.

Second, a textualist theory of interpretation creates an incentive to draft carefully. Under a contextualist theory, a party for whom a deal has turned out badly has an incentive to claim that the parties meant their contract to have a different meaning than the obvious or standard one. Such a party can often find in the parties' negotiations, in their past practices and in trade customs enough evidence to ground a full, costly trial, and thus to force a settlement on terms more favorable than those that the contract, as facially interpreted, would direct. If a party can impeach careful contract drafting with evidence of this type, the rewards to careful contract drafting will fall relative to the costs of such efforts. In consequence, parties will write precise, directive contracts less frequently.

Finally, as suggested above, textualist interpretation permits sophisticated commercial parties to economize on contracting costs by shifting costs from the back end of the contracting process (the enforcement function) to the front end of the contracting process (the negotiating and drafting function). Parties can do this by drafting a merger clause that integrates their entire understanding, including relevant context, into the written contract and then asking the court to apply a plain meaning interpretation to facially unambiguous contract terms. When parties use a merger clause to exclude contextual evidence, an interpretation dispute over contract terms may be resolved on summary judgment. If a court decides to consider additional context evidence, it must necessarily deny a motion for summary judgment and set the case for full trial on the merits. Thus, if litigation cost is considered, there is a strong argument that many commercial parties prefer textualist interpretation so that disputes can be resolved on summary judgment rather than after a full trial. This is particularly true when commercially sophisticated parties have invested resources in extensively drafting the contract (thereby shifting costs to the front end). Such parties will rationally invest in sufficient drafting costs to insure that a court interpreting the written document together with the pleadings and briefs will be able to arrive at the "correct interpretation" more often than not.<sup>43</sup>

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<sup>43</sup> This argument is premised on the claim that firms behave as if they are risk neutral. Risk neutral firms prefer to limit enforcement costs—say by resolving interpretation disputes by summary judgment—so long as the courts' interpretations are correct on average. It follows that sophisticated parties (i.e., firms) are more reluctant to expend resources to shrink the variance

There is some empirical evidence that supports the textualist claim. Recent work by Ted Eisenberg and Geoff Miller studying choice of law and choice of forum clauses in a data set of 2,865 contracts is consistent with a preference for textualism. Their study shows that parties chose New York law in 46% of the contracts and New York as the forum state in 41% of the contracts. California was chosen for its contract law in less than 8% of the contracts, though its commercial activity, as measured by the place of business of the contracting parties, was second only to New York.<sup>44</sup> Geoff Miller attributes this to differences in contract law between New York and California: New York strictly enforces bargains, retains a hard parol evidence and a plain meaning rule and frequently declines to consider context evidence in resolving interpretive disputes. California, in contrast, has a contextualist interpretive regime and is predisposed to consider all material context evidence that litigating parties seek to introduce. Miller concludes that “[t]he revealed preferences of sophisticated parties support arguments by Schwartz, Scott and others that formalistic rules offer superior value for the interpretation and enforcement of commercial contracts.”<sup>45</sup>

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around the correct mean. See Alan Schwartz and Robert E. Scott, *Contract Interpretation Redux*, 119 *Yale L.J.* 926 (2010); and Schwartz and Scott, *Contract Theory*, *supra* note 41, at 573-84 (2003).

<sup>44</sup> Theodore Eisenberg and Geoffrey P. Miller, *The Flight to New York: An Empirical Study of Choice of Law and Choice of Forum Clauses in Publicly-Held Companies' Contracts* (N.Y.U. Law & Econ. Res. Paper Series, Working Paper No. 08-13, 2008), available at <http://ssrn.com/abstract=1114808>.

<sup>45</sup> Geoffrey P. Miller, *Bargaining on the Red-Eye: New Light on Contract Theory* (N.Y.U. Law & Econ. Working Papers No. 131, 2008), available at <http://lsr.nellco.org/nyu/lewp/papers/131>.

## *II. Redrawing the Boundaries of Contract Interpretation*

The preceding discussion underscores the dilemma of a unitary approach to interpretation. So long as the rules of interpretation are regarded as mandatory background procedural rules that apply to all contracts within the relevant domain; and so long as the courts continue to adopt a unitary perspective that demands that these background rules apply to all disputed contracts, the clash of perspectives between textualist and contextualist interpretation will continue unabated. The effects of this conflict are felt both in the confusion faced by transactional lawyers trying to design efficient contracts for sophisticated parties as well as in the risk that consumers may be barred from proving context evidence that rebuts false claims of contractual obligation. In this Part, I outline a straightforward solution to the problem: tailor contract law to fit the very different questions that are raised when interpreting individually designed and standard form contracts.

### *A. Interpretive Rules for Contract Design*

The law's objective should be to identify the empirical conditions under which one interpretive theory is generally superior to the other. A plausible criterion with which to judge the relative efficacy of any interpretive strategy is to select that set of rules which, all else equal, minimizes the sum of interpretive error costs and the costs of contracting. The latter costs include the ex ante costs of specifying the terms of the contract and the ex post costs of enforcement. This criterion argues for granting sophisticated parties the maximum flexibility to shift costs between the front end specification process and the back end enforcement process.

However, the preceding discussion vividly illustrates why contract interpretation remains so bitterly contested. Under the current doctrine, rules of interpretation are understood

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as mandatory and not subject to party choice. Thus, textualist and contextualist theories are posed in opposition, each one claiming the right to govern diverse transactional paradigms. It is inevitable, therefore, that, whichever rule is selected, a substantial number of contracting parties will be disadvantaged in order to advance the interests of others. A necessary corollary of the tradeoff between text and context is that parties will have preferences over interpretative rules. Some parties will prefer a hard parol evidence rule that relies on a narrow interpretive base centered on the parties' writings; others may prefer a soft rule that admits evidence of prior understandings and surrounding context evidence.

Given this heterogeneity, it would seem to follow that whatever interpretive rule a court adopts should be a default. But most commentators and courts believe (at least implicitly) that interpretive rules should be mandatory.<sup>46</sup> And, in fact, the rules *are* mandatory in the sense that parties cannot contract directly for textualist or contextualist interpretive rules. Textualist and contextualist courts differ, however, in the degree to which they permit parties indirectly to control how disputes over their contract are adjudicated. For example, the hard parol evidence rule that textualist courts apply permits the parties to “contract out” either by not integrating their writing fully or by including context evidence in the integrated contract. In contrast, contextualist courts apply an invariant soft parol evidence rule, so that parties cannot narrow the evidentiary base. In contextualist jurisdictions, therefore, contextualism is the only option. The fact that under current law textualism works effectively as a default rule while contextualism is effectively mandatory, argues for textualism as the governing interpretive rule for contracts between sophisticated parties capable of rational contract planning and design.

Two canonical cases illustrate how a textualist regime can function to satisfy sophisticated party preferences for *both* text and context. The first case involves the interpretation of the meaning of express, written contract terms. A dispute over the meaning of

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<sup>46</sup> See, e.g., Steven J. Burton, *Elements of Contract Interpretation* 193-202 (2009). For an argument that interpretive rules should be defaults, see Alan Schwartz and Robert E. Scott, *Contract Interpretation Redux*, 119 *Yale L.J.* 926 (2010).

express terms arises where written contract language has an apparently clear and unambiguous meaning but may be understood in a different way once context evidence is introduced. This issue arises when a term in the written agreement has a plain, unambiguous meaning in the standard language, but one party claims that context evidence will show that the parties attributed a different meaning to the term.<sup>47</sup> As noted above, courts that follow a hard parol evidence rule also tend to follow the plain meaning rule (which does not look beyond the writing to understand what the parties meant), and thus exclude extrinsic evidence to resolve such disputes. Nevertheless, sophisticated parties who prefer to have context evidence considered are not disadvantaged by this rule, as they may so draft the contract, incorporating what context they wish in its express terms.

A variety of contract clauses perform this function. These include (a) “whereas” or “purpose” clauses that describe the parties’ business plan and the transaction;<sup>48</sup> (b) definition clauses that ascribe particular meanings to words and terms that may vary from their plain meaning; and (c) appendices that provide more precise specifications governing performance as well as any memoranda the parties want an interpreting court to use. Alternatively, parties can elect not to incorporate a merger clause into the agreement so that any and all context evidence will be admissible. Parties can also specify in the integrated agreement that the meaning of

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<sup>47</sup> This claim could be based on the argument that other sources of evidence—such as the parties’ prior negotiations—show that the written term is ambiguous, or that those other sources show that the parties attached a specialized or private meaning to the term in question. See, e.g., *Pacific Gas & Electric Co. v. G.W. Thomas Drayage & Rigging Co.*, 442 P. 2d 641 (Cal. 1968).

<sup>48</sup> See, e.g., the “purpose” clause from the Fountain Manufacturing Agreement between Apple Computer, Inc. and SCI Systems, Inc., available at <http://contracts.onecle.com/apple/scis.mfg.1996.05.31.shtml> <http://cori.missour.edu>.

terms should be interpreted according to the customs and usages of a particular trade or industry. Casual empiricism suggests that all of these strategies are pursued in one degree or another by commercial parties writing contracts in textualist jurisdictions.

Contrast the flexibility sophisticated parties enjoy in designing contracts that will be reviewed by textualist courts with the alternative of contract design in contextualist jurisdictions. Under the UCC, trade usage is always relevant and the text of the parol evidence rule appears to exclude context evidence from the operation of a merger clause.<sup>58</sup> Moreover, the Code's rejection of the plain meaning rule means that regardless of the "terms" the court finds to be part of the agreement, the meaning of those terms will always be subject to evidence of contextual understandings that vary from any standard, dictionary meaning. In short, in contextualist jurisdictions, contextualism is mandatory. This means that context evidence will increase accuracy for those cases in which parties intended that apparently standard language should be read in a nonstandard way in light of the underlying commercial context. But if contextualism is the only interpretive style, it necessarily increases contracting costs for some parties: Giving the commercial context interpretive priority (in fact, if not formally) makes much more costly the efforts of those who wish to exclude the relevant commercial context.

The second canonical case, which illustrates the superiority of textualism, is its ability to balance text and context in a way that economizes on contracting costs. Under textualism, the parties may adopt a mixed regime, where some terms are narrowly defined, leaving little room for context; while other terms import imprecise standards, where the courts may fill in the gaps with the benefit of ex post information. This offers a flexibility absent from contextualism, and has not been well recognized by courts or commentators.

Commercial contracts commonly include both precise and vague terms, and the courts

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<sup>58</sup> UCC § 2-202(b) provides that "consistent additional terms" are excluded where the writing was "intended ...as a complete and exclusive statement of the terms of the agreement," but no such exclusion applies to trade usage, course of performance or course of dealing evidence under §2-202(a).

actively interpret and enforce vague terms by reference to context evidence. For example, contracts may condition one party's performance on "commercially reasonable efforts," "reasonable efforts" or "reasonable best efforts."<sup>49</sup> The conventional explanation is that these vague terms act as "catch-alls" that compensate for the under-inclusiveness of precise terms. To the contrary, however, the evidence shows that parties choose their mix of rules and standards to optimize the admissibility of context evidence over two dimensions: *when* the context is incorporated and *who* decides what context matters. The practical choice is between the parties at the time of the contract and the court at the later time of litigation. The parties have the comparative advantages at the time of contracting since they share in the benefits of efficient contracting. But the court does have the benefit of hindsight. In this case, uncertainty has been resolved and the court sees realized facts rather than probability distributions. The parties can't foresee all contingencies so they can delegate to the court the task of completing the contract *ex post* by considering relevant context. They indicate this intention by adopting a vague contract term (or standard). The combination of vague and specific terms thus allows the parties to exploit the information advantages of both the court and the parties.<sup>50</sup>

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<sup>49</sup> See University of Missouri-Columbia, Contracting and Organizations Research Institute, CORI Contracts Library, at <http://cori.missouri.edu> (last visited Feb. 25, 2005). Total contracts in CORI database: 24,965. Contracts with "best efforts" terms: 4,328 (17.34%). Contracts with "reasonable expenses" terms: 2,584 (10.35%). Contracts with "reasonably withheld" terms: 38 (0.0015%). Contracts with "unreasonably withheld" terms: 3,525 (14.12%). Contracts with "reasonable" terms: 13,281 (53.20%).

<sup>50</sup> The options available to the parties are even broader than the stark choice between a rule and a standard. With the aid of interpretation maxims, parties can design combinations of specific and vague terms that more precisely define the "space" within which the court has discretion in proxy choice. For discussion see Scott and Triantis, *Anticipating Litigation*, *supra* note 10.

On the other hand, a court intent on admitting context evidence to determine the parties' actual intent will violate freedom of contract norms if it completes the contract in a way that the parties themselves never would have agreed to. To appreciate how this might occur, it is important to understand how a court's interpretive approach can affect initial contracting costs. Parties that function under a contextualist theory of interpretation may succumb to post-contractual opportunism, strategically urging interpretations that favor their ex post position. This temptation is greater as the complexity of a contract increases. The more complex the contract, the more opportunities it presents for a party to raise an ambiguity in the language. When parties consider which contract form to choose initially, they will anticipate the costs of enforcing the contract they chose. Contextual interpretation thus raises the costs of using complex contracts by impeding the ability of parties to shift costs to the front end of the contracting process when uncertainty is low.

B. *Interpretive Rules for Standardized Contracts*

Assuming, consistent with current law, that textualism and contextualism are regarded as mandatory background rules within their prescribed domains, I next consider the case for a mandatory contextualist rule for standardized contracts—the paradigmatic sales transaction contemplated by Article 2 of the UCC. I argued above that when levels of uncertainty are high, contract designers will shift more costs from the front end of the contracting process to the back end so as to capture the courts' hindsight advantage. Standardized contracts present yet another opportunity to evaluate this trade off. Casual observation as well as theory suggests that when parties contract in well-developed markets, they write simple, “modular” contracts that rely on well-established trade customs and understandings. These pre-existing patterns reduce the costs of ex ante specification but do not significantly increase ex post enforcement costs so long as the court has reliable access to the relevant trade standards. Under these conditions, contextual interpretation will reduce the costs of specifying all of the terms in the written contract because

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parties can rely on courts to recover ex post the understandings that are not explicitly included in the written agreement ex ante. These costs include both the costs of committing to writing the customary understandings in a particular trade or practice as well as the social costs of holding unsophisticated parties to written terms that depart from previously settled understandings.

If these conditions obtain for all (or almost all) sales contracts governed by the UCC, then contextualism could be justified as the preferred interpretive style for resolving such disputes. In fact, however, the domain of sales law under Article 2 is overbroad. It includes both standardized transactions as well as complex sales contracts susceptible to ex ante contract design. Moreover, the argument for incorporation of context rests on the questionable assumption that generalist courts are equipped accurately to incorporate context in the course of litigating disputes over the terms and meaning of written agreements. In Llewellyn's mind, the mechanism for incorporation was to have been the merchant tribunal. The merchant jury was to be a panel of experts that would find specific facts—such as whether the behavior of a contracting party was “commercially reasonable.” Unfortunately, the idea of the merchant tribunal was too radical for the commercial lawyers who dominated the drafting process. Thus Llewellyn abandoned this key device for discovering the relevant context, while still retaining the architecture of incorporation.

To be sure, courts subsequently have interpreted contracts in which context evidence has been evaluated together with the written terms of the contract.<sup>51</sup> But the fact-specific nature of such disputes leaves little opportunity for the context evidence introduced in a given case to serve as useful standardized terms for future parties. Moreover, the court, ignorant of the contracting environment and unaided by experts, may err in evaluating contested context evidence that is introduced by only one of the disputants. As a consequence, neither enhanced accuracy

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<sup>51</sup> The invitation to contextualize the contract in this manner is explicitly embodied in the Code's definition of “agreement” in §1-201(3) and is amplified by § 1-303 which specifies that courses of dealing, courses of performance and usages of trade give particular meaning to, and qualify terms of, an agreement.

nor positive externalities will reliably result from a court's consideration of context evidence in any given sales contract dispute: to this extent, therefore, the incorporation project appears to have failed in implementation.

### ***Conclusion***

The justification for a mandatory contextualist regime rests on the assumption that all contractual transactions are homogeneous. But, to the contrary, contract law applies to a wide range of contexts and parties. Parties are heterogeneous in modern economies; contracts sometimes have to be complex, and parties often must take into account many relevant future states of the world. The greater the heterogeneity of the parties and the greater the variety of contexts to which a particular transaction applies, the more freedom parties must have to draft a written contract that addresses ex ante the particular contracting costs that they anticipate. Because the context in which parties contract is itself heterogeneous, a mandatory contextualist regime, such as that currently adopted by Article 2 of the UCC, is seriously overbroad. In failing to recognize the heterogeneity of commercial contracting, the drafters of Article 2 and the reporters of the Second Restatement as well as the state courts that follow California's lead have contributed to a decline in the quality of American contract law.<sup>52</sup> The merits of flexibility in shifting costs between the two stages of the contracting process override any value in automatically incorporating context in every case. Contextualism for everyone denies too many commercial parties the ability to design contracts efficiently.

The argument for contextualism as a mandatory interpretive rule in a world of

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<sup>52</sup> It is worth noting that in England, as well as most other common law countries that have not experienced the "Realist's revolution," the courts continue to incline more closely to textualism. See Michael Bridge's chapter in this volume. The conclusion in this essay is that American contract law would be better for following that example.

mandatory interpretive rules thus reduces to the regulatory imperative of protecting unsophisticated parties—mostly individual consumers—against the risk of exploitation through deceit and other difficult-to-detect forms of fraud or manipulation of cognitive biases. But if the objective is to regulate consumer transactions in mass market settings, the notion that those interests are best protected through the common law of contract, or that protecting those interests has much to do with the rules of contract interpretation, is simply fanciful. Consumer transactions, and the equitable issues they present, can be better resolved within a regulatory regime separate from the common law rules of contract that govern commercial parties.